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Capacity in the hedge fund industry - is this the right time to invest?

The issues occupying investors at the moment are not what they were before Tuesday 11 September. The impact that events in the USA will have on the direction of the markets, volatility and liquidity are not things we can reasonably speculate about at this stage. Rather, in this article we would like to tackle an issue that has occupied investors, observers and industry participants for some time: capacity and talk of a hedge fund 'bubble'.

The issue arises because hedge funds have generally performed well over the last few years, while stocks have floundered and reminded us that they are risky investments after all. The result is that hedge funds have attracted a great deal of capital, prompting talk of a 'bubble' and questions about whether this is, in fact, a good time to invest in hedge funds.

The term 'bubble' is on investors' minds because of the sharp corrections over the past 18 months to previously irrationally over-valued technology stocks. Trying to draw comparisons between the surge in popularity of hedge funds and the tech stock bubble are not very meaningful. Not least of the reasons is that one cannot bid up the price of hedge funds in the same way that one can bid up stocks.

We think there are really two substantial concerns underlying the speculation about a hedge fund bubble. First, the growing interest in hedge fund investment is leading to capacity constraints in the industry. Second, investors keen to get exposure to hedge funds are not necessarily making sound allocation decisions based on thorough analysis of the skills and experience of hedge fund managers.

The second concern needs little elaboration. Suffice it to say that established hedge fund businesses with robust business infrastructures and long and solid track records are best placed to undertake the key tasks that are integral to successful hedge fund management: short selling, leverage, and – at a higher level – analysis of track records and management skill, the identification and selection of strategies and talented investment managers, portfolio construction and risk management.

The concern about capacity is that the hedge fund industry cannot absorb the kind of capital inflows it is currently experiencing. It is a reasonable concern because hedge fund styles look to take advantage of definite market inefficiencies whose causes and origins are identifiable and understandable. There are obviously some limits on the value that can be added by exploiting these anomalies before spreads narrow and margins get squeezed. However, capacity is influenced by numerous factors and varies across strategies all the time. Much depends on the sorts of market inefficiencies that are exploited by various strategies, the types of investment styles used to exploit these, the investment processes and skills of individual managers, and the liquidity of assets traded.

Those who downplay capacity as an issue in the hedge fund industry often point to the improvement in market liquidity over the years. Trading opportunities have increased as the universe of stocks, derivatives and financial instruments has become larger. It is also true that shorting capability has been enhanced as prime brokerage has become more competitive and brokers have gained experience and confidence to offer increased opportunities to traders. However, the main driver of capacity is the abundance or supply of opportunities, which hinges on the interaction of numerous dynamic economic and market factors. While it is possible that economic circumstances can at different times lead to capacity limitations and undermine the returns of certain styles, it is unlikely that the net effect of even a large number of style-related capacity squeezes at the same time – in itself unlikely – would lead be a 'crash' or 'burst bubble' in the hedge fund market.

Man Management AG
Bahnhofstrasse 15
PO Box 349
8808 Pfäffikon SZ, Switzerland
Tel +41 55 415 36 36
Fax +41 55 415 36 37
www.maninvestmentproducts.com

The number of variables and the variability across strategies make generalisations or clear-cut predictions about capacity in the hedge fund industry difficult. The best one can do is look at individual hedge fund styles and the factors that influence capacity.

The key determinants of capacity for equity long/short and market neutral strategies are stock market liquidity (and volatility in the case of numerous equity market neutral and statistical arbitrage strategies, which tend to trade actively), growth in the number of tradeable stocks and shorting capability. Some analysts argue that the increasing number of active equity-based hedge funds is having the effect of actually improving liquidity in equity markets as hedge funds trade more frequently than traditional mutual funds.

Stock market capitalisation in the US alone is estimated at around US$ 18 trillion and global stock market capitalisation is estimated at around US$ 28 trillion. The hedge fund industry is estimated to be in the region of US$ 600 billion (compared to an estimated US$ 40 trillion for the traditional investment industry), pointing to favourable capacity and potential for growth in equity-based strategies. Long/short equity strategies constitute the single largest strategy segment of the hedge fund industry (around 40%), so this fact alone points to some potential for an expansion of hedge fund investment in general. In the near and longer-term, the capacity of equity long/short and market neutral styles appears fairly good. The volume of publicly-listed equities means that success depends mainly on managers' superior information or superior analytics. Perhaps the biggest challenge with respect to this style group is gaining access to the best managers.

The capacity of merger arbitrage strategies is determined by supply – merger arbitrage deal flow – which has slowed in the last year. A pick up in the merger cycle will depend on an improvement in the global economy, which appears unlikely in the next few quarters. Convertible bond arbitrage opportunities depend largely on new convertible issuance, the quality and price of new issuance, and equity market volatility which enables profits to be made from active adjustment of short equity hedge positions. Although recent new issuance has been favourable in the US and Europe, credit spreads on secondary issues have moved out, which has led to something of a gap opening up between the most skilled practitioners and their peers. Convertible bond arbitrageurs who use tools to hedge out credit risk are better placed than some of their peers to cope with a threat to a blow up in credit - perhaps the biggest risk facing convertible arbitrageurs at present. Some of the strong convertible arbitrage players may continue to produce strong and steady growth in the medium-term, but an overall flattening of returns from this style segment is not unlikely, especially if equity market volatility decreases or credit risk increases.

Capacity in the distressed securities sector is supply-driven, with opportunities dependent on the economic cycle and whether or not the business structures of companies whose securities become distressed are robust enough to justify investment. The current difficult economic situation has produced a greater supply of distressed paper than was available in the recent past. The decline of technology companies could present exciting opportunities depending on whether or not companies make it through restructuring. The key unknown is whether business infrastructures are robust enough. With banks cutting back lending to many companies, strategies that specialise in distressed loans have a great opportunity to actually upgrade the quality of their investments. Most distressed hedge funds have historically been long only, but now there are some attractive opportunities being created by distressed managers who invest on both the short and the long side.

The key determinants of capacity amongst managed futures strategies are liquidity in derivatives markets and the addition of new markets and instruments. Relative to other hedge styles, investor interest in managed futures strategies has grown at a slower pace over the last couple of years. A possible increase in demand for managed futures may be met by expansion of markets and new trading opportunities such as the creation of single stock futures. Momentum based strategies in particular could experience increased interest from investors as profit opportunities may arise from some decisive market trends in the near-term, depending on how the economic situation evolves.

Hedge funds have proven potential to achieve positive returns in falling markets and to outperform traditional investments on a risk-adjusted basis. The growing popularity of hedge funds is attributable to their potential for absolute performance, which is highlighted when stocks enter periods of decline. Even merger arbitrage strategies, which on aggregate have produced disappointing results this year, have, for example, exceeded the

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returns of stocks and have been on par with the returns of most fixed income investments. On average long/short equities strategies have significantly outperformed both stocks and bonds recently, and the outlook is fairly promising for this, the largest hedge fund style segment, as well as equity market neutral, distressed securities and managed futures strategies.

Concerns about capacity in the hedge fund industry should neither be dismissed nor overstated. Lumping all hedge fund strategies together and making sweeping generalisations about the industry as a whole is a mistake - the factors that influence capacity are numerous and change quickly, and capacity varies across strategies all the time. By comparison with traditional investments, hedge funds look particularly attractive at the present time. However, as is the case at an overall portfolio level, the diversification imperative is important when it comes to gaining exposure to hedge fund strategies. Diversification across different strategies helps smooth out the effect of possible above and below-average performance by different styles in various market conditions. It is also important that investment in hedge funds happens only after careful consideration of the track record and experience of hedge fund managers.

Potential investors should note that alternative investments can involve significant risks and the value of an investment may go down as well as up. There is no guarantee of trading performance and past performance is not necessarily a guide to future results.

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Fax +41 55 415 36 37
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